THE SUPREME COURT'S AMBIGUOUS USE OF "VALUE" IN RATE CASES.

At the old common law the purveyors of many services and commodities were required to sell at "reasonable" prices. The reasonableness of the price seems to have been a question for the jury, and no precedents found their way into the law books. When the era of American state and national railroad regulation began, however, in the latter part of the nineteenth century, more systematic inquiries were made. The chief objects of regulation were to prevent improper discrimination between different shippers, and to prevent the charging of extortionate rates to the entire body of shippers. A particular rate might therefore be adjudged too high either because it imposed too great a *share* of the burden on one class of shippers relative to that borne by others, or because it imposed too great a total burden on all the shippers. If the burden was found to be properly distributed over all the classes, a rate was adjudged too high only in case the rates as a whole yielded too much revenue.

Thus the question of the amount of profits that is legitimate became a matter of official concern. There are cases, however, where the receipt of an excessive income may not be a good reason for lowering rates—where it may be considered preferable to divert the surplus to the public in some other manner, as by taxation or by a compulsory wage increase. The question of the amount of profits that is legitimate may therefore, in the future, underlie governmental questions more important than that of rate regulation. But as yet it has scarcely been raised in tax proceedings (except in our recent experiment with excess profits taxes) or in wage disputes. It has been raised frequently, however, in rate cases, and passed upon by commissions and courts. It has become a judicial commonplace that a company is entitled to charge rates sufficient to cover operating expenses, depreciation, and "a fair return" on the "value" (or on the "fair value", as it is sometimes phrased) of its property.

This formulation looks like a solution of the legal question of the legitimacy of the income, requiring only arithmetical ascertainment of certain stated facts. Instead of being a solution, however, the formula leaves the legal question precisely where it was before. The "value" to be "ascertained" is not the objective fact

which the name indicates—it is not the exchange value of the entire property. This will be pointed out more fully in a moment. The "value" on which a return is to be allowed may conceivably be some other objective fact, or it may be the amount to which the exchange value of the entire property *ought* to be made to conform. Therefore, any discussion of what is the best evidence of "value" (whether reproduction cost, for instance, is better evidence than original cost) is evidently futile without an accurate statement of what is meant by "value".

It should, perhaps, be noted that the Supreme Court has stated more than once that there may be exceptions to the requirement that rates must yield a "fair return". In *Covington &c. Turnpike Co.* v. *Sandford*,[1] Mr. Justice Harlan remarked that

> "The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends."

Again in *Smyth* v. *Ames*,[2] he said:

> "What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth."

Again, in *San Diego Land & Town Co.* v. *National City*,[3] Mr. Justice Harlan referred to the actual cost basis as

> "defective in not requiring the real value of the property and the fair value in themselves of the services rendered to be taken into consideration."

Finally, in *Willcox* v. *Consolidated Gas Co.*,[4] Mr. Justice Peckham, after declaring the general rule to be that the company is entitled to the benefit of any increase in land values, added:

> "We do not say there may not possibly be an exception to it, where the property may have increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public."

[1](1896) 164 U. S. 578, at p. 596, 17 Sup. Ct. 198.
[2](1898) 169 U. S. 466, at p. 547, 18 Sup. Ct. 418.
[3](1899) 174 U. S. 739, at p. 757, 19 Sup. Ct. 804.
[4](1909) 212 U. S. 19, at p. 52, 29 Sup. Ct. 192.

To say that the rate must not exceed what the service is reasonably worth, however, means nothing. If the court means what it is worth to each individual patron (what the economists term the "utility" of the service), that differs with each patron. If on the other hand it means the value in exchange (which is equivalent to what the economists term the "marginal utility"), that is by very definition what the company does charge. This is true unless a price is charged which calls forth a demand greater than the company can (or will) satisfy. In such a case the service is worth more than the price asked; the company could charge more without losing patronage. In this sense it would be possible for a rate to be less than the service is worth. It cannot possibly be greater, unless it is so high that nobody will purchase it at all.

In several cases, it may be remarked, the Wisconsin Railroad Commission has interpreted the phrase as justifying the fixing of a rate which will yield less than a fair return in cases where a higher rate would yield still less.[5]

The "value of the services" concept was not needed to justify the commission in the situation described, as it must be quite clear that the company is deprived of nothing at all when its rates are kept down to the point where they yield the utmost net earnings commercially possible. Indeed in another case the commission points out that "reasonable rates"

> "cannot be exclusively measured by what the services are reasonably worth, for this reasonable value is so indefinite a quantity that it cannot always be determined. It may be represented by the cost of substitutes for the services in question; by the cost to the municipality, plus a fair addition for risks of furnishing the same; by what the customers can be made to pay; by the rates charged in other places; and by many other factors."[6]

The United States Supreme Court has not regulated rates itself, but it has frequently decided whether particular regulations made by legislatures or commissions prevent the earning of a sufficient return on a sufficient "value". A little consideration

[5]See, for instance, *In re* Appl. Manitowoc Gas Co. (1908) 3 Wis. R. C. R. 163, at p. 177; State Journal Printing Co. *v.* Madison Gas & El. Co. (1910) 4 Wis. R. C. R. 501, at p. 625; *In re* Appl. Oconto City Water Supply Co. (1911) 7 Wis. R. C. R. 497, at pp. 556-557. In the two cases first mentioned, the remarks of the commission were *dicta,* since a rate sufficent to yield a "fair return" was not out of the question.

[6]Hill *v.* Antigo Water Co. (1909) 3 Wis. R. C. R. 623, at p. 725.

will show, as has been pointed out by more than one writer,[7] that the basis adopted by the Supreme Court has not been the market or exchange value of the entire property of the company. On that basis, no reductions in anticipated net earnings would be permissible. An investor who is considering purchase of the property or of a share of it will value the property by capitalizing the anticipated net earnings at a rate which varies with the risk. It is this rate (a rate sufficient to attract capital) that is generally meant by "a fair rate of return". If the market value is a capitalization of the anticipated earnings, the anticipated earnings must, by hypothesis, constitute a fair return on the market value so long as by "fair return" we mean the capitalization rate. If we mean by "fair return" some higher rate, the anticipated earnings under the existing rates will always be less than a "fair return" on the market value. If we mean by "fair return" a lower rate than that at which the earnings are capitalized in valuing the property, the earnings will always be found to constitute more than a "fair return" on the market value. After each reduction to a "fair return", the market value would shrink and the new earnings would amount to more than a "fair return" on the new value.

Suppose, for instance, that a business is anticipating earnings of $100,000 a year. If the capitalization rate is 10% and the "fair return" but 8%, the business is *worth* $1,000,000 and the anticipated earnings constitute 10% on what it is worth. If the earnings to be anticipated were reduced to the "fair return" of 8%, or $80,000, the value of the business (capitalized at 10%) would fall to $800,000. But even the reduced rates yield 10%, not 8%, on this new value, and a further reduction in the earnings to $64,000 would be permissible, resulting in a further reduction in the value of the business and so on *ad infinitum*.

By defining "fair return", then, in some manner which would make it less than the capitalization rate, we should always find that the earnings anticipated under the present rates were more than a "fair return" on the market value of all the property. But the Court, as we shall see, has held in some cases that the earnings anticipated under the old rates did not constitute more than a "fair return" on the "fair value". If "fair return" be defined as less than the capitalization rate, it follows accordingly that the Court has not permitted earnings to be reduced to a "fair return" on the market value of the entire property.

[7] *Cf., e. g.,* Commissioner Stevens's language, cited *infra,* p. 213.

Again, by defining "fair return" in a manner which would make it equal to or greater than the capitalization rate, we should never find that the anticipated net earnings under the existing rates exceeded a "fair return" on the market value of the entire property. But again the Court has held in some cases that the earnings anticipated under the old rates did exceed a "fair return" on the "fair value". If "fair return" be defined as equal to or greater than the capitalization rate, it follows that the Court has not insisted that earnings constitute a "fair return" on the market value of the entire property. But the Court has clearly stated that earnings may be reduced to a "fair return" (in some sense) on the "fair value" (in some sense), but may not be reduced further. It follows that, since in some cases the earnings must exceed a "fair return" (in one sense) on the market value of the entirety, and since in some cases they may fall short of a "fair return" (in the only other senses) on the market value of the entirety, the Court must have meant by "fair value" something other than the market value of the entirety.

That the Court did not mean to base the "fair return" on an amount which itself varies with the return, is not a matter of inference alone. The Court itself, in justifying the omission of "good will or advantage incident to the possession of a monopoly" from the valuation in *Cedar Rapids Gas Co.* v. *Cedar Rapids,*[8] remarked that

> "if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the Fourteenth Amendment, then the power to regulate is null."

The opinion was rendered by Mr. Justice Holmes. Again in the *Minnesota Rate Cases,*[9] Mr. Justice Hughes refused to calculate the "fair value" of the roadbed by a process which in his view involved

> "an appreciation [*sic*] of the returns from rates (when rates themselves are in dispute)".

In *Des Moines Gas Co.* v. *Des Moines*[10] as well, Mr. Justice Day cited the Cedar Rapids Case in support of his disapproval of a rule whereunder

[8](1912) 223 U. S. 655, at p. 669, 32 Sup. Ct. 389.
[9](1913) 230 U. S. 352, at p. 455, 33 Sup. Ct. 729.
[10](1915) 238 U. S. 153, at p. 171, 35 Sup. Ct. 811.

> "income to which the corporation is not entitled would become the basis of valuation in determining the rights of the public."

It seems evident, then, that the Court has not intended to safeguard a "fair return" on an amount which depends upon the earnings. Since the market value of the entire property is precisely that sort of amount, the Court cannot have intended to safeguard a "fair return" thereon unless it failed to realize that the market value does vary with the earnings. As expressed by Chairman Frank W. Stevens of the up-State New York Public Service Commission[11]:

> "There would seem to be no escape from the conclusion that when courts have used the term 'fair value' in rate cases, they had something in mind different from 'exchange value,' or in other words 'value'. It is not to be supposed that they did not comprehend that value depends upon the rate, and that a change in rate means a change in value if it affects net income."

It is, however, by inference, rather than by the Court's own express language, that it is to be supposed that it comprehended "that value depends upon the rate". Mr. Stevens, in his subsequent career as counsel to the New York Central Lines, apparently lost faith in the conclusiveness of this inference, and made a persuasive argument, based on the language of the decisions, to the effect that the Court meant nothing else than the exchange value of the entire property.[12]

The argument may be sound, but if so it indicates a misunderstanding by the Court of what affects the exchange value. On this supposition its decisions are too hopelessly confused to justify an attempt to draw any conclusions from them at all. It would be impossible to determine whether the Court's real purpose was to safeguard the market value of the entire property (which is inconsistent with permitting any reductions whatsoever in net earnings) or to permit reductions under certain circumstances (which is inconsistent with safeguarding the market value of the entire property). Its opinions would imply both purposes, and both cannot be carried out.

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[11]Fuhrmann *v.* Cataract Power & Conduit Co. (1913), 3 N. Y. P. S. Comm. (2nd Dist.) 656, at p. 681.

[12]See pamphlet entitled "The Valuation of Railroad Right of Way, No. 3" (1914).

While it is not impossible that the Court may have meant to allow a return on the exchange or market value of the entire property, and may accordingly have entertained a purpose inconsistent with its decrees sustaining reductions, it is not necessary to assume that such was its intent. It may have meant by "fair value" either the exchange value of a part only of the entire property, or else something different from exchange value altogether. In many of the cases before it, the opposing contentions concerned the relative merits of various "evidences" of the "fair value"—whether the Court should be guided, for instance, by the original cost rather than by the reproduction cost of the property. Let us see what light can be derived from the Court's action in regard to the various contentions put forward. Is the "fair value" identical with the actual cost, or with the actual cost so far as that was reasonably incurred, or with the cost of replacement new, or with the cost of replacement less depreciation, or with some amount on which all these figures would throw light? Has the Court considered any of these elements, or all of them, as evidence of some other fact? If so, what is that fact?

Taking first the actual decisions of the Supreme Court without regard to *dicta,* we find in the cases of *Reagan* v. *Farmers' Loan & Trust Co.*[13] and *Covington &c. Turnpike Co.* v. *Sandford*[14] that reductions which leave no net earnings at all are invalid. In *Smyth* v. *Ames*[15] a reduction which did leave some net earnings was also annulled. The decision itself, however, throws no light on the question of the basis upon which the reduced rates must yield a fair return, since in that case the reduced earnings, as calculated by the court[16], would yield less than a fair return on any basis contended for. The cases of *San Diego Land & Town Co.* v. *National City*[17], *San Diego Land & Town Co.* v. *Jasper*[18] and *Stanislaus County* v. *San Joaquin C. & I. Co.*[19] decided that a

[13](1894) 154 U. S. 362, 14 Sup. Ct. 1047, *per* Brewer, *J.*

[14]*Supra,* footnote 1, *per* Harlan, *J. Cf. supra,* p. 209, for the exception made by the Court to its general rule.

[15]*Supra,* footnote 2, *per* Harlan, *J.*

[16]The court's calculations (*cf.* p. 547) differed from those made by Mr. William Jennings Bryan, of counsel for the state, on the basis of which he contended (at p. 493) that the reduced rates would yield "a reasonable profit upon the present value of the roads." The decision does not, therefore, amount to a rejection of his conception of "present value * * * as measured by the cost of reproduction" (at p. 489).

[17]*Supra,* footnote 3, *per* Harlan, *J.*

[18](1903) 189 U. S. 439, 23 Sup. Ct. 571, *per* Holmes, *J.*

[19](1904) 192 U. S. 201, 24 Sup. Ct. 241, *per* Peckham, *J.*

reduction was not necessarily invalid merely because the reduced rates would yield less than a fair return on an actual cost *which might be dishonest and extravagant.* As far as the actual decisions in these three cases are concerned, the Court did not have to choose in any of them between the basis of actual cost *so far as that is honest and reasonable* and any other basis. In *Knoxville* v. *Knoxville Water Co.*[20] it was decided that rates need not yield a "fair return" on reproduction cost unless that figure is corrected by deducting depreciation. In *Willcox* v. *Consolidated Gas Co.*[21] and in the *Minnesota Rate Cases,*[23] the "valuation" adopted in the opinions exceeded the actual cost. The reduced rates yielded a "fair return" on the amount adopted, and therefore more than a "fair return" on the actual cost. The rejection of actual cost in the opinions was therefore *obiter dictum.* The case of *Cedar Rapids Gas Co.* v. *Cedar Rapids*[24] decided nothing as to actual or reproduction cost. It decided only that the amount upon which the reduced earnings must yield a "fair return" need not include "the good will or advantage incident to the possession of a monopoly, so far as that might be supposed to give the plaintiff the power to charge more than a reasonable price."

In *San Joaquin Co.* v. *Stanislaus County,*[25] the actual cost basis was distinctly rejected, and a reduction which yielded a "fair return" on actual cost but nothing on the water rights for which the company had paid nothing, was held invalid. The court, however, noted that the circumstances of the case were peculiar, in that only a few specified individuals would benefit from a reduction in the irrigation charges[26]. It would accordingly be unsafe to regard the decision as a precedent in cases where an unlimited class would get the benefit. And in the subsequent case of *Des Moines Gas Co.* v. *Des Moines*[27] the Court rejected reproduction cost apparently in favor of actual cost. It sustained a reduction which would yield the company less than a "fair return" on what it would cost to cut through existing pavements to lay the mains, on the ground that the company had not in fact been obliged to

[20](1909) 212 U. S. 1, 29 Sup. Ct. 148, *per* Moody, *J.*

[21]*Supra,* footnote 4, *per* Peckham, *J.*

[23]*Supra,* footnote 9, *per* Hughes, *J.*

[24]*Supra,* footnote 8, *per* Holmes, *J.*

[25](1914) 233 U. S. 454, 34 Sup. Ct. 652, *per* Holmes, *J.*

[26]"Recurring to the fact that in every instance only a few specified individuals get the right to a supply". (at p. 460).

[27]*Supra,* footnote 10, at p. 172, *per* Day, *J.*

incur that expense, the mains having been laid before the street was paved.

The Supreme Court has never actually *decided,* then, that a reduction which would benefit more than a limited class was invalid when the reduced rates would still yield a "fair return" on the actual reasonable cost. On the other hand it has never held a reduction valid which would yield less than this amount. But it has held valid a reduction which would yield less than a "fair return" on the reproduction cost when undepreciated, and a reduction which would yield less than a "fair return" on the reproduction cost in a case where it was not apparent that depreciation would make any difference[28]. The Court's actual decisions, as distinct from its *dicta,* are quite consistent with a power on the part of commissions to reduce earnings to a "fair return" on the actual reasonable cost. They do not require a return on the reproduction cost, new or depreciated.

The Court's *dicta,* however, as distinct from the decisions, require a return on an amount which may be greater or less than the actual reasonable cost. This "fair value", according to Mr. Justice Harlan in *Smyth* v. *Ames*[29], is something which is to be found by giving "such weight as may be just and right in each case" to various elements, including the original cost and the replacement cost. According to the same justice in *San Diego Land & Town Co.* v. *National City*[30], it is "the reasonable value of the property *at the time it is being used for the public.*" Mr. Justice Peckham tells us in *Willcox* v. *Consolidated Gas Co.*[31] that "if the property * * * has increased in value since it was acquired, the company is entitled to the benefits of such increase." Finally in the *Minnesota Rate Cases*[32] Mr. Justice Hughes says:

> "It is clear that in ascertaining present value we are not limited to the consideration of the amount of the actual investment. If that has been reckless or improvident, losses may be sustained which the com-

[28]Knoxville *v.* Knoxville Water Co., *supra,* footnote 20; Des Moines Gas Co. *v.* Des Moines, *supra,* footnote 10.

[29]*Supra,* footnote 2, at p. 547.

[30]*Supra,* footnote 3, at p. 757. The italics are mine. The case was cited with approval by Mr. Justice Holmes, in San Diego Land & Town Co. *v.* Jasper, *supra, f*ootnote 18, at p. 442, and by Mr. Justice Peckham, in Stanislaus County *v.* San Joaquin C. & I. Co., *supra,* footnote 19, at p. 215.

[31]*Supra,* footnote 4, at p. 52. For a possible exception to the rule here laid down, see *supra,* p. 209.

[32]*Supra,* footnote 9, at p. 454.

> munity does not underwrite. As the company may not be protected in its actual investment, if the value of its property be plainly less, so the making of a just return for the use of the property involves the recognition of its fair value if it be more than its cost. The property is held in private ownership and it is that property, and not the original cost of it, of which the owner may not be deprived without due process of law."

These *dicta* make it clear that the Court does not intend in all cases to permit rates to be reduced to the point where they yield a "fair return" only on the actual reasonable cost. They must yield a return on an amount which may happen to exceed that cost at the time of the regulation. Yet this amount is not necessarily identical with what it would cost to replace the property at the time of the regulation, or with such replacement cost less depreciation. Mr. Justice Moody in *Knoxville* v. *Knoxville Water Co.*[33] referred to reproduction cost as *"one way of ascertaining* the present value," and Mr. Justice Hughes in the *Minnesota Rate Cases*[34], referred to the cost of reproduction "method" as *"of service in ascertaining* the present value". And as we have seen, the Court sustained a reduction in the Des Moines case[35] which yielded less than a "fair return" on the cost of replacing at the time of the decision. What is, then, the "present value" or the "fair value", upon which the rates must yield a "fair return"? Let us recall that, unless the Court was hopelessly confused, the "fair value" is not the market value of the entire property.

The Court must have meant one of two things by "fair value". It may have meant the existing market value of the physical property plus perhaps a *reasonable amount* of the market value of the intangible elements (or plus, perhaps, the entire market value of the franchise as distinct from the other intangibles). It may on the other hand have meant by "fair value" the amount which it considered reasonable to permit the value of the entire business to attain. Neither alternative is entirely consistent with all of the Court's language.

There is a sense in which the exchange or market value of the physical property may be differentiated from that of the entire business. The exchange value is what someone *would* pay, if the

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[33] *Supra,* footnote 20, at p. 9. Italics are mine.

[34] *Supra,* footnote 9, at p. 452. Italics are mine.

[35] *Supra,* footnote 10, at p. 172. See, *supra,* p. 215.

property is not in the actual process of being exchanged. An outsider buying the physical property from the company to operate it with all the rights now possessed by the company, would pay as much as the market value of the entire business. He would not distinguish between the physical property and the "intangibles". The company, however, already in possession of the "intangibles", would not necessarily pay the owner of the physical parts of the property as much as this. It would pay no more than what it would have to pay for a substitute which, from the point of view of revenue production, would be equally efficient. It would not pay that much if the business as a whole had a market value which was less. Taking the market value of the physical property, then, to mean what the company would pay for that property to one who was not himself possessed of the operating rights, that value cannot exceed the market value of the whole, but it may fall short thereof. If it does fall short thereof, the difference between the "physical value" and the market value of the entirety would be the value of the "intangibles"—the franchise, "good will", "going value" and the like.

The Court may have intended to allow a "fair return" on the "physical value" as defined above. To allow a "fair return" (in the sense of the capitalization rate) on the "physical value" is to preserve that value from impairment. This could be done while at the same time permitting reductions in net earnings whenever they suffice to create an "intangible" value. As we shall see presently, however, the Court has not excluded all "intangibles" from the "fair value" on which the "fair return" must be based, and in the Des Moines Gas case, as we have seen already,[36] it allowed a reduction which left the company less than a "fair return" on what it would at the time cost to replace with an equally efficient substitute. It is not clear, however, that it intended in this case to allow a reduction to less than a "fair return" on the market value of the physical property, since it is not clear that the Court understood the relation between the existence of the paving and the market value of the gas mains. Mr. Justice Day seems to have thought that the paving did not in fact increase the market value of the mains. He said:[37]

[36]See, *supra*, p. 215.

[37]*Supra*, footnote 10, at p. 172.

> "The Master reached the conclusion that the life of the mains would not be enhanced by the necessity of removing the pavements, and that the Company had no right of property in the pavements thus dealt with, and that there was neither justice nor equity in requiring the people who had been at the expense of paving the streets to pay an additional sum for gas because the plant, when put in, would have to be at the expense of taking up and replacing the pavements in building the same. He held that such added value was wholly theoretical, when no benefit was derived therefrom. We find no error in this disposition of the question."

It is quite true that the value of the entire business is not necessarily enhanced by reason of the paving. The right to own the mains themselves, however, is more valuable when that ownership saves the company from incurring a large expense than it was when it saved the company from incurring a smaller expense only.

The point that the company did not own the pavement had also been made by Judge Miller of the New York Court of Appeals, in *People ex rel. Kings County Lighting Co.* v. *Willcox*.[38] In rejecting paving costs not incurred by the company, he said among other things:

> "The case is not at all parallel to the so-called unearned increment of land. That the company owns. It does not own the pavements, and the laying of them does not add to its investment or increase the cost to it of producing gas."

No more, of course, does the increase in the value of land. But if we are after the value, not the cost, the right of ownership in the *pavement* makes no difference. The value of the right to own the main, not the pavement, is greater by reason of the obstacle which the paving (whoever owns it) offers to the acquisition of equally efficient mains in the same streets. Owning mains already laid is of more benefit to the owner than it would be if they could be more cheaply replaced—unless, of course, the earning-value of the mains were less even than the replacement cost in unpaved streets. The right to own a factory may be increased when competing foreign imports are excluded by a customs tariff. This fact would not be negatived by the fact that the owner of the factory does not himself own the customs houses.

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[38](1914) 210 N. Y. 479, at p. 495, 104 N. E. 911.

The Court has not excluded all "intangibles" from the "fair value". In *Willcox* v. *Consolidated Gas Co.*[39] Mr. Justice Peckham remarked:

> "It cannot be disputed that franchises of this nature are property and cannot be taken or used by others without compensation. * * * The important question is always one of value."

If it were intended to include the value of all the "intangibles", the Court must either use the word "value" in some other sense than market value, or else it would get into the difficulties noted above in the discussion of the market value of the entire business. In dealing with the franchises, however, it is quite possible that the Court did not mean to include all of the intangible value. In this very case it excluded the "good will"[40], though possibly because none was thought to exist.[41] In *Cedar Rapids Gas Co.* v. *Cedar Rapids,*[42] Mr. Justice Holmes remarked:

> "Then again, although it is argued that the court excluded going value, the court expressly took into account the fact that the plant was in successful operation. What it excluded was the good will or advantage incident to the possession of a monopoly, so far as that might be supposed to give the plaintiff the power to charge more than a reasonable price. *Willcox* v. *Consolidated Gas Co.,* 212 U. S. 19, 52. An adjustment of this sort under a power to regulate rates has to steer between Scylla and Charybdis. On the one side if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the Fourteenth Amendment, then the power to regulate is null. On the other hand if the power to regulate withdraws the protection of the Amendment altogether, then the property is nought. This is not a matter of economic theory, but of fair interpretation of a bargain. Neither extreme can have been meant. A midway between them must be hit."

[39] *Supra,* footnote 4, at p. 44.

[40] At p. 52.

[41] The reasoning as to franchises is a little obscure. The Court allowed a value equal to the amount at which the franchises of the constituent companies had been capitalized at the time of the consolidation, but refused to allow the alleged subsequent increase in value for which the company contended. Though the reasoning on the two points is not wholly consistent, the language indicates a search for the exchange value of the franchise as well as of the physical property.

[42] *Supra,* footnote 8, at pp. 669-670.

This might indicate an intention to safeguard the market value of the franchise alone (if that is distinguishable from the value of the intangibles as a whole), or else as an intention to safeguard so much of the value of all the intangibles as to the Court might seem fair.[43] Even if the latter was the Court's intention in dealing with "intangibles", it does not preclude the intention of safeguarding a "fair return" on the market value of the physical property plus the "fair amount" of the intangibles. But the former intention (to safeguard a fair return on the market value of the franchise while not protecting the other intangibles at all) is quite consistent with the decisions as to intangibles.

The existence of an intangible value is not to be accounted for exclusively by the possession of a franchise. If capital were perfectly free, not only legally but practically, to enter or leave the business in any quantity, large or small, there could be no intangible value. Sufficient capital would flow in to reduce the earnings until they sufficed only to attract the capital necessary for building a substitute—in other words until the market value of each concern as an entirety was equal only to the cost of building a substitute. The fact that capital is not free to enter may be due either to legal prohibition of its entry (as where the existing company has an exclusive franchise), or to other business circumstances. Among the latter may be mentioned "good will", "unfair practices" and the mere advantage of being first in a field where the demand for the services is sufficient to create an intangible element of value as long as the existing company is the only producer, without being sufficient to induce an outsider to enter that field and thereby cut down the value by adding to the supply. This last situation is due to the necessity of large-scale production, and would not be present where small-scale production is equally economical.

Only to the extent that the absence of competition, and the consequent presence of intangible value, is to be accounted for by legal prohibition, can that value be attributed to the franchise. The franchise consists of the right to exclude and the right to operate. The right to operate can have no value apart from the right to own the physical property. It is by virtue of the right to operate that the value of the pyhsical property exceeds its junk value. That right accounts, then, for part of the value of the physical property (just as the right to make shoes accounts

[43]For a further discussion of the implications of this language, see *infra*, footnote 54.

for part of the value of shoe machinery), but for none of the "intangible" value. As much of the latter as cannot be accounted for by the right to exclude, is therefore not franchise value at all, but the value of the other intangibles. In practice it would be difficult if not impossible to ascertain precisely how much of the intangible value is that of the franchise.

If the market value of the physical property (and of the franchise) is what is meant by "fair value", the constitutional theory of the Court would seem to be as follows: For the state to destroy part or all of the value of all intangibles except the franchise by reducing rates is either a deprivation of property, albeit *with* due process of law, or else no deprivation of property at all, the word "property" being used by the court in a sense to exclude all "intangibles" other than the franchise. For the state to destroy any part of the value of the tangible property (and perhaps of the franchise), on the other hand, by reducing rates, is not only a deprivation of property, but is *without* due process of law, no matter what grounds of public policy might be adduced for this destruction. If this is the theory on which the Court has been acting, its discretion in each case is limited to the ascertainment of a fact—how much the tangible property (and perhaps the franchise) is actually worth. If this is not the theory, the Court is not ascertaining a fact but is determining a question of policy—namely, to what level a state ought to be permitted to reduce the value of the entire property of a public service company.

If the Court is determining a policy, the constitutional theory would be, not that the destruction of any part of the value of the tangible property plus franchise is a deprivation of property without due process of law, but that the destruction of *more* of the value of the entire property than the Court thinks it "fair" to destroy would be a deprivation without due process. As long as the reduced rates yield a "fair return" on what the Court thinks fair, the deprivation of property would be *with* due process.

If the Court is using "fair value" in the sense of *the amount which it thinks fair,* then the Court in each case (except where controlled by its own precedents) is determining public policy rather than ascertaining a fact. But the language and reasoning of the decisions seem as a rule to imply a search for a fact, not a determination of public policy. They seem to imply, further, that the Court is endeavoring to protect some parts of the property from any impairment in value whatsoever.

Thus as early as January 4, 1886, Mr. Chief Justice Waite declared by way of *dictum* in *Stone* v. *Farmers' Loan & Trust Co.*[44] that "This power to regulate is not a power to destroy". In *Ames* v. *Union Pacific Ry.*[45] Mr. Justice Brewer, sitting as a circuit judge, referred to the rule safeguarding "a fair interest on the actual value of the property" as equivalent to the requirement of the payment of the "present value", "not the cost" in condemnation proceedings. On January 12, 1909, in *Willcox* v. *Consolidated Gas Co.*[46], Mr. Justice Peckham said:

> "If the property, * * * has increased in value since it was acquired, the company is entitled to the benefit of such increase. This is, at any rate, the general rule. We do not say there may not possibly be an exception to it, where the property may have increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public."

He cannot be using "value" in the sense of the amount which the court thinks just. The Court could hardly think that circumstances might arise in which it would be unjust to the public for the company to collect from it the amount which it would be just to collect.

Shortly before this (on January 4, 1909), Mr. Justice Moody spoke of "ascertaining" the value, in the Knoxville case[47]. On June 9, 1913, Mr. Justice Hughes said in the *Minnesota Rate Cases*[48] that the "ascertainment" of the "fair" or "reasonable" value is not "a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts."

All the above expressions seem to indicate that the Court was seeking to ascertain the fact of what the value *is,* rather than to determine a policy of what it ought to be. This indication is not seriously weakened by the rejection in the Minnesota case of the company's use of "multipliers" as applied to the value of the lands adjacent to the railroads. The rejection was based partly on the entirely tenable ground that it would be impossible to show what

[44]Railroad Commission Cases (1886) 116 U. S. 307, at p. 331, 6 Sup. Ct. 334.

[45](C. C. 1894), 64 Fed. 165, at 177.

[46]*Supra,* footnote 4, at p. 52.

[47]*Supra,* footnote 20, at p. 9.

[48]*Supra,* footnote 9, at p. 434.

the roadbed would cost to reproduce, since the adjacent lands had a value largely dependent upon the existence of the railroad.[48a] It was based also on the additional ground that[49]

> "The increase sought for 'railway value' * * * is an increment which in the last analysis must rest on an estimate of the value of the railroad use as compared with other business uses; it involves an appreciation of the returns from rates (when rates themselves are in dispute)".

It is likely that the court momentarily lost sight of the fact that, if judged by other business uses, the locomotives and rails would not have any value at all above that of old iron. The court seems to have feared that to allow a return on the value of the physical property for railroad uses would preclude the possibility of reducing the net earnings—forgetting that it might be quite possible to find earnings in excess of a fair return on the replacement cost, hence on the (railroad) market value of the physical property.

While most of the language of the Court indicates an attempt to ascertain the fact of value, we must not forget that in the Des Moines case[50], whether consciously or unconsciously, the Court permitted a reduction which would yield less than a fair return on the value of the physical property, and that here and there we find an expression which could be interpreted as an attempt to determine policy. Such, for example, is a statement in the Des Moines case[51] (quoting with approval the report of the master) that

> "there was neither justice nor equity in requiring the people who had been at the expense of paving the streets to pay an additional sum for gas because" *etc.*

The Court has never said unequivocally, then, whether "due process of law" precludes any reduction whatsoever of the exchange value of the physical property (and of the franchise proper), or whether it precludes such reduction in the value of the entire business as to the Court may seem too much.

Assuming for the moment that the Court has meant to safeguard the physical value (and perhaps the value of the franchise as distinct from the other intangibles) from impairment, it is

[48a] At. p. 452.
[49] At p. 455.
[50] *Supra,* footnote 10.
[51] At p. 172.

worth noting at this point one or two facts in regard to the ascertainment of the physical value. The physical property, as already noted, cannot exceed in value what it would cost to build a substitute which, from the point of view of revenue production, would be equally efficient. An equally efficient substitute does not mean a superior one, and if the existing plant is partly worn out its value cannot be as great as the cost of replacing with a wholly new plant. With the latter the accumulation of the replacement fund could be postponed further into the future, and the annual contributions to that fund could be less than when the plant is partly worn out. The *net* earnings from the new plant would be greater, since a smaller annual amount is to be deducted from the *gross* earnings to care for depreciation. The cost of an equally efficient substitute cannot, therefore, exceed the cost of replacement new, minus accrued depreciation (unless, of course, a partly accumulated depreciation fund goes with the old plant).

While the exchange value of the physical property cannot exceed the cost of replacing it with an equally efficient substitute, it is not necessarily as great as this. It cannot exceed the capitalized anticipated earnings of the business.[52] One would not pay more for the physical property of a utility company than that property was worth as a revenue producer, however much it might cost to replace it. This being the case, if the Court's only object is to prevent destruction of any part of the exchange value of the physical property (or of the "intangibles" too, for that matter), that object can as a rule be attained without granting an increase in the anticipated earnings. If the net earnings anticipated have always been less than a fair return on the replacement cost, the exchange value of the physical property is likewise less, and on that value the anticipated earnings already constitute a "fair return".

While it would therefore be beyond a state's power (on the constitutional assumption we are now making) to impair by rate reduction any "unearned increment" which may already have accrued, it would be within its power to prevent the accrual of any future "unearned increment" in the value of the property of public service companies. This it could do by forbidding the col-

[52]Unless, indeed, it could be sold for more to another kind of business. Its value for the other business, however, could not possibly be impaired by reducing the earnings of the regulated business. If the Court means to prevent any destruction of the value, it is only necessary to allow a return (equal to the capitalization rate) on the value which the physical property possesses for the purpose of the regulated business.

lection of any net earnings beyond those already anticipated in the case of existing companies, and beyond a stated percentage of the capital invested in new companies, except upon securing the affirmative permission of the regulating commission.

If at the time of investment precise notice had been given the investors of the basis upon which a fair return was to be permitted, nothing more than a "fair return" upon that announced basis would be anticipated. The value would never exceed the amount of the basis, and the net earnings could be kept down by the state to the notified level without impairment of the value. The state might in such a case be constitutionally required, perhaps, to permit an increase in the *rates* when necessary for keeping the net earnings up to the old level (by reason of increased operating expenses). It might even be required, in case the current interest rate had advanced, to permit an increase in the net earnings to the point where they constitute the new and higher rate on the announced basis.[53] Except in such cases, however, a state could use its own discretion whether to permit any increase at all in net earnings, provided it had given the precise notice prior to investment. This is on the assumption that the court has intended to safeguard a "fair return" on the exchange value of the physical property (plus perhaps the franchise), with the object of protecting that value from impairment.

It is not entirely clear, however, that the court meant by "fair value" the exchange value of the physical property (plus the franchise). It may have been determining a question of policy after all. Should it declare unequivocally that this is what it has been doing, then its declarations (by way of *dictum*) that "fair value" may exceed the actual reasonable cost would be declarations of what in its opinion is sound public policy. Those declarations have all been made, however, in cases where the state was attempting to reduce rates, never where the state was refusing to permit an advance. In the cases before the Court, the proposed reductions would affect the interests of those who invested without precise knowledge of the basis which the state was intending to adopt. The Court has never stressed that fact, but it is possible that it might recognize a distinction between a state's reduction of earnings and a state's refusal to permit earnings

[53]Unless the company had waived its right by the terms of the franchise which it had accepted. Even without this waiver, however, it is conceivable that the Court might draw a distinction between cutting the value down by reducing earnings and cutting it down by refusing to permit earnings to increase.

to increase. Or again, instead of drawing this line, it might distinguish between all those regulations which prevent earnings reaching the level which the investors have been permitted to anticipate, on the one hand, and those which from the very outset limit the amount which the investors may anticipate, on the other. In the former case the owner is likely to have paid more than he would have been willing to pay had he known what the state would do, and is in need of greater constitutional protection than had he invested with his eyes open.

Whether the Court would be inclined to make this distinction, however, is a matter for speculation. In any event, if the Court has been determining a question of policy rather than protecting the value of the physical property from impairment, we are in the dark as to what it has thought to be good policy in the cases before it. If the Court has not indeed been requiring a fair return on the exchange value of the physical property, neither has it on the replacement cost (new or depreciated), on the actual cost, or on the actual cost so far as it was reasonably incurred. Each of these bases has been rejected as the sole criterion, and if the criterion is something else on which all of these throw light, and if that something else is not the exchange value of the physical property (plus that of some of the intangibles), the Court has never revealed what it is or could be. It is true that the rejection of actual cost, where reasonable, has been only by way of *dictum*, but the *dicta* have been clear and emphatic. If the Court is declaring policy, what it rejects as the criterion of the best policy is clear enough. It seems to reject every definite conceivable basis. What it accepts is vague and indefinite.[54] It is only on the

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[54]In regard to franchises or donated property, Mr. Justice Holmes seems to have intimated that he thought it essential that the rates should suffice to give such property some market value. He seems to have been speaking of property in a franchise when, in Cedar Rapids Gas Co. *v.* Cedar Rapids, *supra,* footnote 8, at pp. 669-670, he said that "if the power to regulate withdraws the protection of the Amendment altogether, then the property is nought," implying that this would not be a "fair interpretation of a bargain." Again in the San Joaquin case, *supra,* footnote 25, at pp. 460-461, he held that since the state court had held that water appropriated from a stream for irrigation was private property, "it is unreasonable to suppose" that the provisions of the state constitution as to water rates "meant to compel a gift from the former owner to the users and that in dealing with water 'appropriated for sale' it meant that there should be nothing to sell."

As a matter of fact there is no logical necessity for permitting the franchise or other donated property to have any exchange value at all. The purpose of granting the franchise (or other property) would not be nullified by refusing to permit it to acquire a value. The fact that the company may lawfully operate and the fact that it can actually collect even as

hypothesis that it is protecting the exchange value of some portion of the entire property from impairment that its declarations (except in the Des Moines case) are reasonably consistent, definite and clear.

In the present state of the law, we cannot be sure what the Supreme Court means to protect under the name of "fair value". Some future decision may clear up the matter. If the present confusion is not to continue, the Court will have to adopt one of the following positions, with the results indicated:

(1) It may hold that it has meant to protect the market value of the entire property, and that its decisions sustaining the validity of reductions were mistaken. This position would preclude all reductions in net earnings by way of rate regulation, but would not necessarily preclude legislatures or commissions from checking all increases in net earnings except such as appeal to the legislative or administrative, rather than the judicial sense of sound policy.[55]

(2) The Court may hold that it has meant to protect the market value of the physical property only, or at most of the physical property and the franchise as distinct from the other intangibles. It will then have to reverse its decision as to pavement over mains in the Des Moines case. This position would not preclude all reductions in net earnings, and, as in the preceding case, would not preclude the checking of increases in net earnings.

(3) The Court may hold that it has meant to protect so much of the market value of the entire business as to it seems fair. In that case it would be necessary to state more clearly what amount it does think fair to protect. Not only would reductions, in this case, have to conform to the judicial sense of sound policy rather than to the administrative or legislative sense thereof; it is possible that action checking advances in earnings would have to meet the Court's approval. Whether the Court's rejection of

much as the permitted net earnings are what give its property a market value equal to the amount upon which the permitted net earnings constitute a "fair return." A "fair return" on the cost of replacing the physical property with equally efficient substitutes would result in no market value at all for the franchise. Even when the franchise has no market value, however, it is worth having. Without the right to operate, the rest of the property would have but a junk value. Without the exclusion of others the rest of the property might be reduced in value by cut-throat competition. The apparent paradox that a thing may be worth having even if it has no exchange value (even if it is not worth paying for because one can obtain it without paying—like air) has been familiar to economists since the days of Adam Smith.

[55]With the qualifications mentioned, *supra*, p. 222.

actual reasonable cost in reduction cases indicates its disapproval thereof in advance cases, would remain to be decided; as would also the Court's positive conception of what it considers fair in reduction cases.

Pending the Court's clarification of its own meaning, there seems no reason why commissions should not discriminate between existing and future investments, and announce precisely to what extent and under what circumstances they will allow increases of returns in the former cases and any returns at all in the latter. Except for the returns already anticipated on the existing investments, the amount of returns permitted could be made to conform to the commissions' ideas of sound policy (subject to the possibility that the Court may ultimately decide otherwise). The question of policy has not been discussed in this article, but in cases where precise notice has been given to the investors there seems little reason for considering any question but the amount of return necessary to secure the needed capital and efficient management. That question is itself difficult enough, but its consideration would eliminate much of the labor now spent by commissions on "valuation" matters not relevant to it. It might also serve to develop a working conception of fair profits which could be applied in the broader field of taxation.

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